Money Market Equilibrium

ECO 420 Lecture 4.1.

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3 Feb. 2010

Outline

The Liquidity Preference Framework

What is the liquidity preference framework?

Definition: The Liquidity Preference Framework (LPF)

LPF is a *model* of supply and demand for money developed by J.M.Keynes that predicts the equilibrium interest rate on the money market

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- Money does not bring interest
- Interest rate on bonds is $i > 0$

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From equilibrium follows:

$$B_s + M_s = B_d + M_d \Leftrightarrow B_s - B_d = M_d - M_s$$

The Liquidity Preference Framework

What happens if the interest rate i rises?

What happens if the interest rate i rises?

- bond prices go down

The Liquidity Preference Framework

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- expected return on bonds goes up

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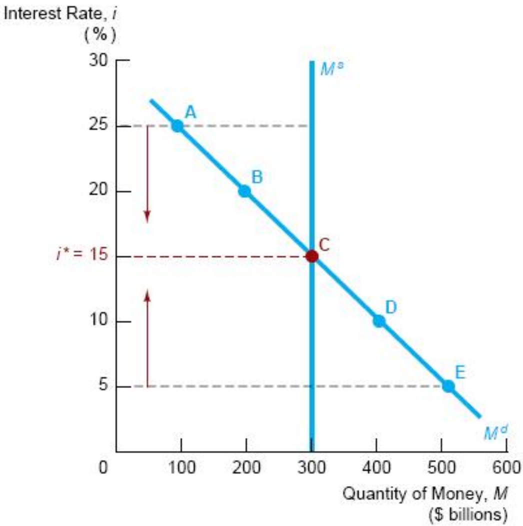
Opportunity cost explanation for the decline in money demand

The Liquidity Preference Framework: A Graphical Analysis



Changes in The Liquidity Preference Framework Equilibrium

Two main factors for change in demand for money:

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- wealth increases $\Rightarrow$ money demand increases

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Any objections?

Asset Demand Framework

Differences Between the Asset Demand and LPF

The case of wealth and money demand

Asset Demand Framework

- Wealth $\uparrow \Rightarrow$

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- Price of bonds

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- Wealth $\uparrow \Rightarrow$
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- Interest rate

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LPF (Keynes)

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- Interest rate $\downarrow \Rightarrow$
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- Money demand $\uparrow$

The **Classic LPF explanation**:

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The **Classic LPF explanation**: Wealth $\uparrow \rightarrow$ people want to hold more money for the increased number of transactions $\uparrow \rightarrow$ money demand $\uparrow$.

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Differences Between the Asset Demand and LPF

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- Inflation $\uparrow \Rightarrow$

Differences Between the Asset Demand and LPF

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- Inflation $\uparrow \Rightarrow$
- Exp.Ret. on Real Assets

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The **Classic LPF explanation**: Inflation $\uparrow \rightarrow$ money are worth less $\rightarrow$ people want to consume the same quantities of goods $\rightarrow$ nominal money demand $\uparrow$.

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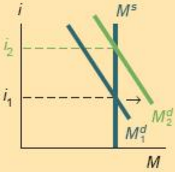
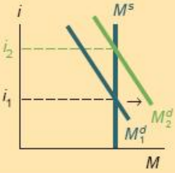
Which theory is the correct one?

Factors Shifting the Demand for Money

A summary

Variable	Change in Variable	Change in Money Demand (M^d) or Supply (M^s)	Change in Interest Rate	
Income	↑	M^d↑	↑	
Price level	↑	M^d↑	↑	

Factors Shifting the Supply of Money

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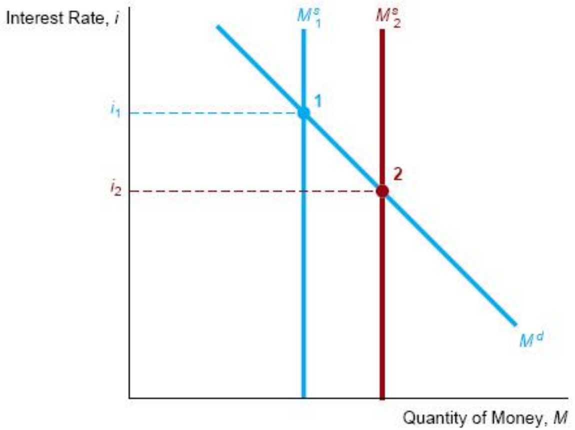

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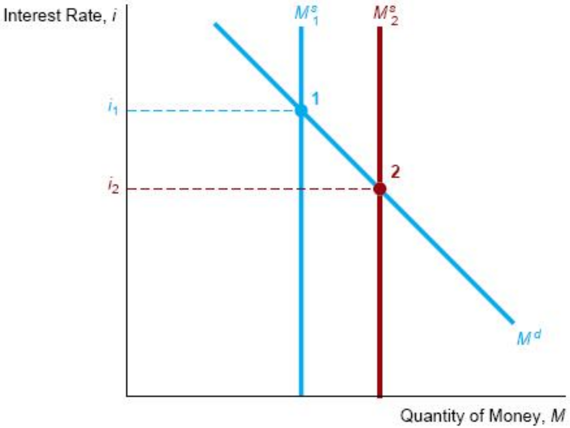

Is that always the case?